INSTITUTE FOR REAL ESTATE OPERATING COMPANIES
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TSCG

Market considerations for investors in the evolving retail property sector

David McWhorter, Institutional Real Estate, Inc.'s managing director, iREOC and capital markets consulting, recently spoke with Atlanta-based **Sam Latone,** president and CEO, partner, of TSCG (formerly The Shopping Center Group), about the evolving retail sector. Following is an excerpt of that conversation.

Tell us a bit about TSCG. What makes the firm unique?

TSCG was founded in April of 1984, when retailers were beginning to look beyond the enclosed mall environment at community-oriented open-air shopping centers, in a move designed to get closer to the customers at a significantly reduced occupancy cost. Until this time, with less complicated site-selection programs based on the philosophy that if it's good enough for Sears, Macy's and Penney's, it's good enough for them, retailers had "followed the packs" of the other national retailers to enclosed malls. This comfort level, along with boiler-plate leases achieved by repeated transactions with the same mall owners, resulted in very limited internal real estate departments. As retailers ventured outside the mall into the open-air shopping center environment, retailers quickly came to realize they needed dependable local market knowledge to fully understand market dynamics, such as demographics, transportation patterns, access, visibility and many other nuanced complications. TSCG was founded to provide those retailers with an outsourced real estate department, to essentially do that site selection for them.

That was the catalyst to start TSCG. Today, we exclusively represent more than 560 users of space in at least one or more of our markets. The term "user," reflects our involvement in the site-selection strategies of retailers and restaurants, and in addition, service, hospitality, medical and other tenants that have come to recognize the value of locating in an open-air shopping center environment.

Following the founder of the company's retirement and buyout in 1991, the company started to diversify geographically and by discipline. Our geographical growth was predicated on retailers' growth programs that were extending beyond Atlanta to the secondary and tertiary cities in surrounding states. To provide our clients with the local market knowledge they deserve and validate on that commitment to them, we opened offices in Nashville and Charlotte, N.C., followed by Raleigh, N.C., Birmingham, Ala., Memphis and several more throughout the southeastern United States. Today, we have 20 offices from New York to Miami, with unparalleled real-time local market knowledge. With only two exceptions, Tallahassee and Pensacola, Fla., we now have offices within two hours of every East Coast MSA with a population exceeding 100,000. In our view, providing our clients with this kind of local market knowledge and presence is a huge differentiator. Second, we started to get into the landlord-services businesses of leasing, property management and investment sales. By design, our landlord-services platform is structured like an operator of real estate, as opposed to a brokerage company. Today, we're leasing more than 700 properties within our region totaling more than 61 million square feet, which when compared with the public open-air shopping center REITs, puts us third nationally in terms of portfolio size.

During the Great Recession of 2008, it became clear to us that, to minimize the risk of failure, retailers and landlords would be scrutinizing their real estate much more diligently. To meet this need and create an additional differentiator, we decided to double down on our analytics and GIS platforms. This would result in an enhanced opportunity to aid our clients with a site-selection and property acquisition/asset management process that merged true local market knowledge with objective customer profiling and data. In essence, this helps us, our clients and investors to de-risk decision making.

The fourth business vertical came in 2017, when we acquired Hart Realty Advisors, a 20-plus year-old company focused on traditional separate account investment management. The business had grown to almost $1 billion of assets under management, with capital primarily provided by state pension plan sponsors. In 2019, as a result of a fortuitus encounter at an iREOC conference, we began to think the best way to scale this business line was to pivot toward sponsoring investment programs and retooling to become a vertically integrated operator. That fortuitus encounter was with Russell Platt, CEO of Forum Partners. In May of 2022, Forum acquired an entity-level position in TSCG. As a result, TSCG is scaling its investment platform not only as a way to further enhance entity value for this business line, but also as a highly complementary multiplier to drive added opportunity to all business lines.

Retail has been out of favor for many investors. What are the supply/demand characteristics in the retail sector?

The supply and demand fundamentals of retail are probably as strong as I have seen in my entire career. For this discussion, I'm going to differentiate between open-air shopping centers and malls since they are such different animals. About 10 years ago, there were approximately 2,000 malls in the United States. Today, there are fewer than 1,000. The malls that are left fall into two categories: (1) Fortress malls owned generally by the publicly traded companies that have appropriately evolved and stayed relevant and in line with consumer preferences and shopping dynamics, and (2) B and C class malls, typically in secondary markets, that are holding on for dear life and — for all practical purposes — it is not "if" but rather "when" they close down and become something else entirely.

Nationally, vacancy rates in open-air shopping centers are about 5 percent. In some markets in the Southeast, such as Nashville, Raleigh and Charlotte, vacancy rates are 2 percent or less, and we've had virtually no supply added to the marketplace in the past several years. With current land, labor and construction costs, and interest rates being where they are, most anchor tenants can't afford to pay the rents landlords need to make the economics work on new development today. I saw a recent research piece that validated this by calculating that on a national basis, rental rates would need to increase by more than 50 percent to justify new development with any scale.

Do you have some specific examples?

First, we have a high-performing grocery-anchored center with a major state pension plan, that initially looked like a

strictly core investment. After we got involved, we acquired a 10,000-square-foot multi-tenant building in front of the center and a two-acre parcel fronting the frontage road, with the only access being through our shopping center. As of today, we've negotiated and recorded a reciprocal easement agreement with the grocer that allows us to develop two out-parcel pads, with users with whom we're currently in negotiations for ground leases. This is an example of our using our local market knowledge and operational expertise and implementing our strategy of achieving core-plus returns from what, to the rest of the world, would be looked at as a core investment.

The second example is a center we have with a pension plan sponsor in a university town, which I would refer to as our medium-lift strategy. When we got involved, it was a 200,000-square-foot center on approximately 30 acres, anchored by a high-performing grocer, with a significant amount of big-box vacancy. It was built in the late 1970s and looked like it. We were successful in backfilling the big-box space with best-in-class discount retailers. Next, we did an extension with the grocer for a new 15-year primary term with options. As part of the lease-negotiation process with the new junior anchors and the grocer, we were able to get approval to create two 6,000-square-foot out-parcels. Finally, we put together a plan for a complete facade update to give the property a whole new look. Following the completion of the facelift, this is an example of taking what looked like a C-plus class asset and transforming it into a totally new and improved investment-grade property.

In a third example, we have another property with a state pension plan sponsor on the ring road of a regional mall with an exceptionally successful grocery anchor, and three discount soft-goods concepts, all of which are top five in their chains. The center is located in a zoning overlay that allows for 12 stories of densification. We're in the process of finalizing a lease to relocate one of the junior boxes, which will free up that junior box and an adjacent out-parcel, which allows us to go vertical with 220 multifamily units. That's what we call a densification strategy, or the heavy lift. This is example of taking an investment that, on the surface, looked to be core-plus, and when complete, we will achieve value-added returns.

The fourth and final example is our basis-play strategy. We identify a center we like that has been undermanaged and underleased, where we are acquiring the center substantially below replacement cost. We implement a plan to remerchandise the center and, as leases expire, we can mark-to-market rents. Generally, we look for these opportunities where we can achieve opportunistic returns.

The COVID-19 pandemic had a significant impact on retailers. How are retailers doing today?

Prior to the pandemic, under the challenges of Amazon and other ecommerce outlets, the prospects for brick-and-mortar retail appeared dim. A couple things changed during the pandemic. First, since the advent of ecommerce, retailers have increasingly come to learn bricks-and-mortar retail is a critical part of their logistics system. Big-box retailers, in particular, now know that if you use your store as last-mile delivery offering same- or next-day service to the customers closest to their stores, it's much more efficient and effective than warehouse fulfillment centers three time zones away. This results in a substantial decrease in customer acquisition costs, the most critical metric involving ecommerce order fulfillment today.

Second, if you have a buy-online / pick-up-in-store order, there is a multiplier effect, with people picking up in the store typically buying two to three times what they ordered online.

Third, there is the halo effect, where if a retailer opens a store in a particular zip code, online sales will increase by as much as 30 percent in that zip code. Conversely, if they close stores in that particular trade area, online sales will drop by as much as 30 percent in that trade area. The halo effect, which was first studied by ICSC, has statistically proven itself to be accurate.

During COVID-19, necessity retailers had to remain open with basics, such as food and clothing. Fast-food and casual restaurants did a tremendous business with takeout or delivery. Post-COVID, we saw a huge spike in foot traffic and sales, as people who enjoyed the shopping experience and social interaction were able to go back into the stores. Since that time, foot traffic has started to level off, but it's clear people do really want to shop in stores. As a result of the combination of all of these factors, retailer/restaurant sales trends in almost every category are very strong.

Where are the most attractive opportunities for investors in retail in the next two years.

In the investor community now, with returns achievable in the fixed-income space, there is very little core and core-plus money available for new acquisitions. Most of the demand we are seeing from investors is in the value-added and opportunistic space. As long as interest rates remain high, we'll continue to focus on these opportunities. Core and core-plus have the added challenge in achieving positive leverage, while value-added and opportunistic strategies can and usually do. That said, we have seen a few instances where investors are buying core and core-plus assets with cash and waiting until interest rates drop. Then, when they put debt on them, it becomes accretive and can achieve higher risk-adjusted returns. Certainly, this is a strategy we would strongly embrace as a sponsor and operating partner.

As we look to the balance of this year, the sentiment among capital providers and users of capital has improved since the first of the year, not because interest rates are coming down, but rather because, relatively speaking, rates are stable, and investors and operators are getting more comfortable with valuations. Consequently, we are seeing a lot more opportunities and transaction activity this year than we've seen in a while.

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Since 1984, **TSCG's** retail-focused real estate platform has provided a full assortment of advisory services to tenants, landlords, developers, investors and financial institutions, along with investment opportunities to our institutional limited partners. With 20 offices throughout the eastern United States, we are the largest privately held firm in our field in the United States.
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